IN THE MATTER OF THE APPLICATION REGARDING CONVERSION OF PREMERA BLUE CROSS AND ITS AFFILIATES

Washington State Insurance Commissioner's Docket # G02-45

PRE-FILED DIRECT TESTIMONY OF:

Donna C. Novak
President and Chief Executive Officer
NovaRest, Inc.

March 31, 2004

CONFIDENTIAL and PROPRIETARY
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Table of Contents for Ms. Novak's Pre-filed Direct Testimony

I. INTRODUCTION

Q. **Please state your name.**

A. My name is Donna C. Novak.

Q. Please identify your company and your position in it.

A. I am the President and CEO of NovaRest, Inc ("NovaRest"). NovaRest is a consulting firm that was formed to provide cost effective actuarial and management consulting services. It assists both regulators and insurers.

My office is located in suburban Chicago at 980 Eastshore Drive, Suite 100, Fox Lake, Illinois 60020.

II. SUMMARY OF TESTIMONY

Q. Please summarize your testimony.

A. There are two principal points that I make in my testimony. First, Premera is considerably constrained in its ability to access the capital it will need to compete and grow in the future. This is because for year-end 2002 Premera's Risk Based Capital ("RBC") level was only 406% , compared to the 600% average of many other Blue Cross Blue Shield Plans and to the 500% RBC target of similar companies.

Second, the best way for Premera to obtain additional capital is to raise it through the equity markets. This is a superior method when compared to any of the alternatives, such as sale of assets, mergers, attempting to increase profits, or going into debt.

My testimony also discusses four related issues: (1) what the RBC requirements and standards are for health insurance companies; (2) how a company's need for capital restrains its ability to compete and grow; (3) what Premera's alternative sources of capital are; and (4) where Premera stands, in terms of RBC requirements and its capital

constraints, in comparison with its competitors. It is important to note that, whether they are for-profit or not-for-profit, all insurers still have similar profit needs in order to continue to meet increasing RBC requirements.

III. PROFESSIONAL CREDENTIALS

Q. Please tell us your educational background.

A. I graduated from DePaul University in 1972 with a BA in Mathematics and Business. I did post-graduate work in mathematics at the Illinois Institute of Technology. And I have an MBA in Health Management and Finance from the Kellogg School at Northwestern University.

Q. Are you also a accredited actuary?

A. I am. I am a Member of the American Academy of Actuaries (MAAA). I'm also a Fellow of the Conference of Consulting Actuaries (FCA) and an Associate of the Society of Actuaries (ASA). I take continuing education programs each year so as to meet the requirements of the American Academy of Actuaries that are necessary to be able to sign public statements of actuarial opinion.

Q. Have you been active with the Academy of Actuaries?

A. I have. As an Academy member, I have participated in many activities, including working with congressional staff designing the Health Insurance Portability and Accountability Act (HIPAA). I also advised the Medicare Commission and reviewed the Health Care Financing Administration's risk-adjuster mechanism for Medicare.

Q. Are you a member of any other professional organizations?

A. Yes. I am a Fellow of the Life Management Institute (FLMI) and a Health Insurance Associate (HIA).

Q. Please give some examples of the work that you have done for insurance commissioners and regulators.

A. I was retained by the Department of Insurance and Securities Regulation ("DISR") for Washington, D.C., to assist it in its Form A filing hearing regarding the business affiliation of the DC Blue Cross Blue Shield Plan and of the Maryland Blue Cross Blue Shield Plan into the non-profit insurer, CareFirst. I was also retained by the DISR at the time that CareFirst proposed to convert to a for-profit and be purchased by WellPoint. I also wrote a report for the Delaware Attorney General regarding the Delaware Blue Cross Blue Shield Plan's affiliation with CareFirst. I was also retained by the Vermont Department of Insurance in regard to the demutualization of National Life of Vermont.

Q. Did you have a role in developing a manual used by the National Association of Insurance Commissioners ("NAIC")?

A,. Yes. My firm was hired by the NAIC to write the NAIC's Health Financial Analyst Manual.

Q. Have you done any other projects involving the NAIC?

A. I have. In connection with my work with the Academy of Actuaries, I helped develop the Managed-Care Organization Risk-Based Capital ("MCORBC") formula for the NAIC as well as the Health Reserve Guidance Manual. And because I specialize in predicting the cost of health care insurance reform, as well as measuring the financial health of insurers, HMOs, and health care providers, I have worked with state regulators and the NAIC to implement new insurance reform regulations.

Q. Please describe some of your experience in the field of capital requirements and sources of capital for health insurers.

A. From 1993 to 1997, I worked for the Blue Cross and Blue Shield Association ("BCBSA"). One of my duties was to financially monitor BCBSA plans around the country. For example, when a Blue Cross or a Blue Shield plan was beginning to have trouble with its RBC level, I would participate in, or lead, teams that would go out to the company and examine its finances and infrastructure, in an effort to help it turn around.

After leaving BCBSA, I've had occasion to provide consulting services to a number of Blues regarding capital requirements. For example, I was retained by Blue Cross Blue Shield of Florida to analyze its RBC situation and make recommendations as to how it could improve the situation.

I've also given presentations at the Society of Actuaries meetings on RBC topics related to the health insurance industry.

Q. Please give us a summary of your employment history.

A. I have been fortunate to have had a very broad range of work positions in the health and actuarial fields. I worked in the actuarial department for CNA Financial Corp. I've also worked for Bankers Life and Casualty and for Trustmark Insurance Company.

Most of my career has been as a consultant in various aspects of the health insurance business. I've been a self-employed consultant, as I am now, and have also worked as a consultant employed by William M. Mercer, Inc. and by Deloitte & Touche LLP.

In summary, over the last 30 years I've done a variety of health insurance finance and actuarial work for both state insurance regulators and for health insurance companies.

Q. Do you have a curriculum vitae that summarizes your educational, professional and employment history?

A. A true and correct copy of my curriculum vitae is attached hereto as **Exhibit A** and incorporated herein by reference; it will be marked as a Premera Hearing Exhibit.

IV. THE NOVAREST EXPERT REPORT

Q. Have you submitted an expert report in this proceeding?

A. Yes. I am the main author of NovaRest's report, entitled "Capital Requirements and Sources of Capital," dated November 10, 2003 (the "NovaRest Report"), which will be marked as a Premera Hearing Exhibit. I incorporate the NovaRest Report into my Pre-filed Direct Testimony by this reference.

Q. What subjects does the NovaRest Report discuss?

A. The NovaRest Report discusses issues related to the capital requirements of Premera. The Report explains the concept of RBC levels as used in the health insurance industry. It then discusses the minimums for RBC that are imposed, either by statute or by the standards of the BCBSA. It looks at the impacts of capital constraints on corporate decisions. It also provides an overview of alternative sources of capital. And it looks at Premera's and other Blue Plans' RBC levels as of the end of 2002.

Q. What is your conclusion as to whether Premera is "capital constrained"?

A. Based on its RBC levels and RBC requirements, Premera is presently in a weak capital position and must be considered capital constrained. This may result in a variety of negative consequences if Premera's capital level is not increased to a level that is more comparable to the RBC levels of other Blue Plans.

V. DETAILED ANALYSIS

A. Requirements regarding RBC Levels

Q. What do you mean by the term "RBC level" and how is it calculated?

A. An RBC level is a ratio based on a formula that the NAIC developed. The formula is complicated, but in simplest terms, it measures the capital that an insurance company has and compares it to the capital that the company is required to have as defined by the NAIC formula. The formula is based on statutory accounting principles, which are different than GAAP accounting principles.

The formula results in a capital requirement that is then compared to actual capital, resulting in a RBC ratio typically ranging from 200% to over 900%. Because it is a ratio, a company's RBC level can be increased by either increasing the amount of actual capital or by reducing the amount of capital needs calculated by the NAIC formula..

Q. **Does the NovaRest Report provide more detail regarding the RBC formula?**

A. It does. In NovaRest's Report, there is a detailed discussion of the NAIC formula in Appendix A, which is entitled "Risk-Based Capital."

Q. Now, as I understand it, the NAIC formula for calculating RBC levels is used by the state insurance commissioners, by the BCBSA and by health insurance companies. Is that correct?

A. Yes, it is. The same formula is used, but there are different required "minimum" levels utilized by each of those three users.

Q. What are the requirements of the State of Washington regarding RBC levels?

A. Washington has two regulatory RBC limits. If a company falls below 200% of RBC, it can be required to prepare a corrective action plan and the company is subject to regulatory oversight of that plan by the Commissioner. If the RBC level falls to 100%,

then even more drastic action is authorized, including taking over the operation of the company. Obviously, a company never wants to get close to either of these regulatory limits.

Q. What are the BCBSA requirements regarding RBC levels?

A. In order to be permitted to use the Blue Cross Blue Shield name and marks, each Blue Cross Blue Shield plan (hereinafter, I will refer to such Blue Cross Blue Shield plans as "Blue Plans") must comply with the BCBSA's licensure standards. Those standards include minimum RBC requirements applicable to all licensees.

An RBC level below 375% is not acceptable to the BCBSA. A Blue Plan that fell below this level would be monitored by the BCBSA and required to take steps to bring its capital back to acceptable levels. As I mentioned earlier, when I was working for BCBSA, one of my jobs was to help monitor such "at-risk" companies.

Further, if a Blue Plan's RBC level falls below 200%, the Blue Plan loses its Blue Cross Blue Shield license and its right to use the Blue name and mark, which would be a disastrous consequence for a Blue Plan.

Q. Why does the BCBSA set RBC standards that are above the state statutory requirements?

A. For a number of reasons. First, the BCBSA believes that the prudent minimum for an RBC level is significantly above the levels at which an insurance commissioner is authorized to take drastic regulatory steps. The BCBSA's experience is that an RBC level of at least 375% is necessary for financial soundness of the individual Blue Plan. This is because it may be too late to recover if a Blue Plan waits too long before addressing its capital problems. The reality is that if a Blue Plan waits until it is actively in financial trouble, it has significantly fewer options to raise capital.

Second, the BCBSA understandably wants to protect, on a national level, the Blue brand. If any Blue Plan becomes subject to regulatory involvement, that can harm the public confidence in all the Blue Plans.

Q. Is it in the public interest for a company like Premera to maintain RBC levels well in excess of the BCBSA minimum of 375%?

A. It certainly is. Capital levels comfortably in excess of the BCBSA minimum enable the company to make additional investments in better products and services without concern that a sudden cost increase will drive the company's RBC level below the BCBSA minimum. The public in general benefits when a health insurer improves its products and services.

Q. Do companies also set their own RBC target levels?

A. Companies do set their own target levels for RBC. It is beyond the scope of my testimony to support any particular RBC target for Premera, as specific targets should be determined using actuarial models. However, based on my experience with other Blue Plans, a target above 500% would be appropriate for a Blue Plan with similar risks to Premera to adopt. A minimum 500% RBC target would be based on the types of risk found in Blue Plans and the fact that in most cases there is no parent entity to provide quick access to capital to the Blue Plan when it needs it.

Q. What was Premera's RBC level as of the end of 2002?

A. As of year-end 2002, Premera's RBC level was 406%. This is a relatively weak capital position. For example, it is only slightly above 375% and it would take very little for Premera's RBC level to fall to 375%, at which point it would be faced with BCBSA monitoring.

Any gain in RBC level in one year is, of course, subject to the possibility of a loss in the following year. Circumstances that could lead to a further deterioration in a company's capital position include situations where profits are not stable, or special risks are present, or unplanned capital investments have to be made. The RBC level can also be impacted by other factors such as additional growth in the company or by a downturn in the investment market.

B. Premera's Need For Corporate Capital

Q. How is term "capital" used in the NovaRest Report?

A. In not-for-profit health insurance companies, the excess of assets over liabilities is commonly referred to as statutory reserves rather than capital and surplus. In the NovaRest Report and in my testimony, I am using the term "capital" to refer to the excess of assets over liabilities on a statutory basis.

Q. Why does a health insurance company like Premera require capital?

A. Capital is needed to meet regulatory requirements -- both those imposed by the state and those required as a condition of maintaining the BCBSA license -- to make capital improvements, and to ensure the company has the financial strength to pay all claims and other expenses. The need for capital will not disappear or even diminish, so a method of satisfying these needs has to be found.

Q. Are there other reasons why companies like Premera need capital?

A. There certainly are. In addition to regulatory capital requirements, companies need capital for capital expenditures. Capital expenditures are often needed to increase capacity, improve efficiency or to provide up-to-date services in a changing environment, since retained profits may not be sufficient. Examples of such expenditures are making

operational systems more efficient; making policyholder information easily accessible online or through call centers: and providing disease management support -- all of which are increasingly in demand by insureds.

Even if a company had sufficient capital according to its balance sheet, it may not have sufficient liquid assets to make the improvements necessary to execute strategic plans. In order to react to changing technology and regulatory requirements, companies must have capital above that demanded by the minimum RBC requirements.

In addition to keeping up with new technology, companies see growth as a way to best leverage their resources and provide efficient operations. Growth can come from an increased customer base due to population growth or from competing well for customers, but either way, growth increases capital requirements.

C. Premera's Potential Sources of Capital

Q. What are Premera's potential sources of capital?

A. There are a limited number of sources of capital for Premera. Each potential source of capital has varying costs, effect on future profits, and value in meeting regulatory requirements.

Premera's proposed conversion is expected to provide additional capital through the sale of stock. There are many advantages to raising capital through the sale of stock compared to other alternatives. Perhaps the most important advantage is that equity capital does not have to be repaid. Providing a return on stockholder investment is less of a problem, because most or all of the required return on stockholder investment comes from increases in the stock price. The increase in stock price is a natural result of new

retained earnings already required to meet increasing RBC requirements. In addition, the equity market can be a source for future funding.

The other ways that Premera might raise capital consist of selling assets, merging with other companies, increasing profits, or taking on new debt. However, all of these methods are problematic, and are less desirable than a stock sale as a capital-raising strategy. For example, while assets might be sold, capital will not increase unless the admitted value of the asset is less than the amount for which the asset can be sold. Moreover, most assets that are undervalued in this manner increase profit (either through direct profits such as an HMO subsidiary or through reduced costs such as owning a building versus paying rent). Selling the asset means that the profits from the asset are no longer available to the company. Finally, the sale of an asset is a one-time event, and there is no potential future capital build-up or capital infusion once the asset is sold.

Merging with another company may be another way to generate capital if the merger partner has excess capital and/or if the efficiency of the merged entities can be increased by eliminating or selling redundant operations after the merger. However, most regulators place strict restrictions on post-merger flow of capital, reducing the likelihood that merger is a viable way to transfer capital. In addition, while profitability may improve in the long run from eliminating redundant operations, the costs of a merger transaction reduce capital for both entities in the short run. Finally, many companies resist a merger as a solution to a capital problem because they lose autonomy, particularly as the merger partner is most commonly an out-of-state entity (which would also reduce local control and local presence).

While capital can be increased by raising profits, it is not practical to increase profits enough in the short-term to provide significant capital. For any company to increase profits, it has to either charge customers more, pay suppliers less, or operate more efficiently. The first two methods run the risk that customers (*i.e.* insureds) and suppliers (*i.e.* medical care providers) will leave the insurer. The third method is always a desirable goal, but very difficult to implement in a manner that creates substantial capital increases, particularly when care has to be taken that the "efficiencies" do not impact customer service to the point where members leave the Plan.

Q. **What about taking on new debt or using "surplus notes"?**

A. The final method of acquiring new capital (at least in the short term) is to take on new debt. However, traditional loans do not increase capital, since the liability for the loan cancels out the capital on the Plan's books.

There is a type of debt instrument known as a "surplus note" that increases capital, because no liability for the note is established. However, surplus notes must be approved by insurance regulators and cannot be repaid without regulatory approval. In some cases, regulators have even refused to allow the payment of scheduled interest payments. Because of their risk and recent regulatory opposition, surplus notes are all but impossible to obtain, and even if one could find an entity willing to write a surplus note, it would be very expensive.

I should also point out that a surplus note typically involves obtaining approval from the state regulators from two states: the state of the Plan providing the surplus note and the state of the Plan receiving the surplus note. Therefore, even if Washington were

to allow Premera to receive a surplus note, the state regulator of the Plan providing the surplus note may not approve the issuance of the surplus note.

D. The Appropriate RBC Target for Premera

Q. How does Premera's RBC level compare to that of other Blue Plans?

A. Premera has consistently had one of the lowest RBC levels of the Blue Plans. At the end of 2002 it was at 406% or $311.6 million. The RBC position of Premera in comparison to other Blue Plans is illustrated by a graph on page 17 of the NovaRest Report.

Q. What are the RBC levels that other Blue Plans around the country have?

A. The system-wide average RBC level of the Blue Plans is over 600%. Appendix B to the NovaRest Report shows the RBC levels of Premera and 14 other Blue Plans. While there are a few lower than Premera's, there are many Blue Plans that are well in excess of Premera's year-end 2002 level of 406%. The Blue Plans with the higher RBC levels have the capital resources necessary to grow and they also have a safety margin to protect against potential adverse circumstances.

Q. What is the appropriate RBC target for Premera?

A. Specific RBC targets are set based on a company's growth, risk tolerance, ability to recover from adverse development, and strategic plans. For me to provide a specific RBC target for Premera would involve extensive actuarial and financial modeling, which is beyond the scope of this assignment. However, based upon my experience with other Blue Plans similar to Premera, an RBC of 500% or above is an appropriate target for Premera.

Q. What would it take for Premera to reach a 500% RBC?

A. Premera's year-end 2002 RBC level was 406%. Because RBC is a ratio, RBC can be increased by either increasing the asset/income side or decreasing the expense/risk side. If one were to focus solely on the asset/income side, it would require at least a $72 million increase in capital to reach a minimum target of 500% RBC, based on 2002 year end financials. Naturally, the financial results in future years would require a different calculation to determine how much would be needed to reach that 500% target in future years.

Q. What is the best source of additional capital for Premera?

A. As I have previously testified, and as is discussed in section IV of the NovaRest Report, raising capital through the equity markets is the best source of additional capital for Premera, and is a superior method when compared to any of the alternatives, such as the sale of assets, mergers, attempting to increase profits, or going into debt.

. . . . . .

Q. Does this conclude your pre-filed direct testimony?

A. Yes

VERIFICATION

I, DONNA C. NOVAK, declare under penalty of perjury of the laws of the State of Washington that the foregoing answers are true and correct.

Executed this ____ day of March, 2004, at Fox Lake Illinois.

/s/
DONNA C. NOVAK

CURRICULUM VITAE

NAME

Donna C. Novak

BUSINESS ADDRESS

NovaRest Consulting
980 Eastshore Dr. Suite 100
Fox Lake, Illinois 60020
Phone: 847-973-2833
E-mail: Donna.Novak@NovaRest.com

EDUCATION

DePaul University, BA in Mathematics and Business, 1972
Post graduate work Illinois Institute of Technology, 1972-1973.
Northwestern University (Kellogg), MBA in Health Management and Finance, 2000

CONTINUING EDUCATION

An estimated 160 hours annually of sessions at the National Association of Insurance Commissioners (NAIC) quarterly meetings

Prepare and speak annually at Society of Actuaries (SOA) meetings

Meet all continuing education requirements of the American Academy of Actuaries necessary to sign public statements of actuarial opinion

MEMBERSHIP IN PROFESSIONAL ORGANIZATIONS

Fellow of the Conference of Consulting Actuaries (FCA)
Associate of the Society of Actuaries (ASA)
Member of the Academy of Actuaries (MAAA)
Fellow, Life Management Institute (FLMI)
Health Insurance Associate (HIA)

EMPLOYEMENT HISTORY

NovaRest, Inc.	2002- present
William M Mercer, Inc	2000-2002
Deloitte & Touche, LLP	1997-2000
Blue Cross And Blue Shield Association	1993-1997
Trustmark Insurance Company	1991-1993
William M Mercer, Inc	1984-1990
Bankers Life And Casualty	1983-1984
Self-employed Consultant	1977-1983
CNA Financial Corporation	1969-1977

PROFESSIONAL ACTIVITIES

Prior Vice-Chair of the AAA Health Practice Council

Prior Vice-President of the AAA Financial Reporting Council

Vice-President of the Conference of Consulting Actuaries

Led numerous AAA projects including the project to draft the NAIC Health Reserve Guidance Manual

Participated in numerous AAA projects including the project to develop the NAIC Risk-based Capital standard

Exhibit A

PROFESSIONAL ACTIVITIES (Continued)	Member of the General Committee of the Actuarial Standards Board
PROFESSIONAL EXPERIENCE	Hired by the NAIC to write the NAIC Health Financial Analyst Manual Provided actuarial support and advice to state teacher's insurance trust Perform regulatory health insurance rate reviews Provided actuarial audit support for a "big four" accounting firm Developed a corporate strategy for the Federal Employees Program of a large BlueCross BlueShield Plan Senior actuary and team leader responsible for financial monitoring of BlueCross and BlueShield Plan performance. Monitoring included financial forecast monitoring and claim reserve review Provide consulting services to state regulators reviewing carrier business affiliations and mutual holding company conversions Help clients determine optimum capital level for financial protection Prepare rate filings for Medicaid Risk contracts and Federal Employee Health Benefit Plan contracts Regulatory reserve reviews of HMOs. BlueCross BlueShield Plans and commercial carriers Perform federal audits of Medicare Risk Plans
PROFESSIONAL PUBLICATIONS	AAA Professional Practice Notes Article in the National Underwriter on Health Trends Chapter on Gross Premium Calculation in the SOA Textbook on Group Insurance
PROFESSIONAL PRESENTATIONS	Speak regularly at Society of Actuaries meetings on such topics as: Professional Standards Health Risk-based Capital Health Reserving Regulatory issues and trends California Department of Managed Health Care Solvency Board on HMO financial standards National Conference of Insurance Legislators on AHPs NAIC Conference on the Uninsured on state solutions to the uninsured
EXPERT TESTIMONY	District of Columbia Form A filing hearing in the business affiliation of the DC BlueCross Blue Shield Plan and the Maryland BlueCross BlueShield Plan in to CareFirst Delaware Form A filing hearing in the business affiliation of the Delaware BlueCross BlueShield Plan and CareFirst Arbitration hearing concerning the Las Vegas Firefighters Health and Welfare Performed the role of arbitration in a case concerning the assumption reinsurance and service agreement between two health insurers